# EFN REPORT

# ECONOMIC OUTLOOK FOR THE EURO AREA IN 2012 and 2013

**Winter 2011/12**

# About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Pierre Werner Programme of the Robert Schuman Centre for Advanced Studies at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/DepartmentsAndCentres/RobertSchumanCentre/Research/Economic MonetaryPolicy/EFN/Index.aspx.

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## Highlights

- At the end of 2011, prospects for the world are clouded. The main cause for concern is that the euro area crisis of confidence has not reached its peak yet. It is doubtful whether Italian and Spanish debt service would be sustainable if yields stay at these levels for long. Even more critical are the financing conditions for European banks whose standing crucially depends on the valuation of the sovereign bonds they own. This uncertainty will continue inducing firms and households to postpone decisions on spending and investment, and fiscal policy will dampen demand further. Besides, financial conditions are also bound to deteriorate in most member countries. Moreover, weak demand from advanced economies is dampening the expansion in export-oriented emerging markets countries (in East-Asia, but also in Latin America). As a consequence, both our forecasts for the euro area exports and industrial production have been revised downwards.

- For the euro area, we expect GDP to grow by around 0.3% in 2012 and 1.2% in 2013, substantially less than in previous reports. Still, in our central scenario European policy will, in one way or another, prevent insolvencies of states or major banks because the political will to defend the common currency is in place.

- Due to weak growth dynamics and stagnating or falling commodity prices, worldwide and euro zone inflation will calm down in the coming months. Our inflation forecast is 1.8% for 2012 and 1.3% for 2013. This gives room for the ECB, and other central banks, for a clearer expansive monetary stance, as suggested in our previous report.

## Table 1 Economic outlook for the Euro area

| | 2009 | 2010 | 2011 | 2012: 1st half | | 2012: annual | | 2013: annual | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Point Forecast | Interval Forecast | Point Forecast | Interval Forecast | Point Forecast | Interval Forecast |
| GDP | -4.2 | 1.9 | 1.6 | 0.3 | -0.3<br>0.9 | 0.3 | -0.3<br>1.0 | 1.2 | 0.3<br>2.0 |
| Potential Output | 1.7 | 0.5 | 0.7 | 1.0 | 0.9<br>1.1 | 0.9 | 0.8<br>1.0 | 0.8 | 0.6<br>0.9 |
| Private Consumption | -1.2 | 0.9 | 0.4 | 0.3 | -0.3<br>0.8 | 0.3 | -0.3<br>1.0 | 0.8 | 0.1<br>1.6 |
| Government Consumption* | 2.5 | 0.4 | 0.1 | -0.3 | | -0.3 | | 0.2 | |
| Fixed Capital Formation | -12.0 | -0.7 | 2.3 | 0.7 | -1.1<br>2.6 | 1.0 | -1.0<br>3.1 | 2.2 | -0.1<br>4.5 |
| Exports | -12.8 | 11.1 | 6.6 | 4.7 | 3.4<br>6.0 | 5.1 | 3.8<br>6.4 | 6.9 | 5.4<br>8.3 |
| Imports | -11.6 | 9.3 | 4.9 | 3.9 | 2.6<br>5.3 | 4.7 | 3.3<br>6.1 | 7.1 | 5.6<br>8.7 |
| Unemployment Rate | 9.6 | 10.1 | 10.1 | 10.4 | 10.2<br>10.6 | 10.6 | 10.3<br>10.9 | 11.2 | 10.6<br>11.7 |
| Labour Cost Index | 2.7 | 1.6 | 3.3 | 2.9 | 2.4<br>3.4 | 2.8 | 2.2<br>3.3 | 2.4 | 1.8<br>3.0 |
| Labour Productivity | -2.4 | 2.3 | 1.2 | 0.6 | 0.0<br>1.1 | 0.9 | 0.4<br>1.4 | 1.6 | 1.0<br>2.2 |
| HICP | 0.3 | 1.6 | 2.7 | 2.1 | 1.6<br>2.6 | 1.8 | 1.1<br>2.5 | 1.3 | 0.4<br>2.3 |
| IPI | -14.8 | 7.4 | 3.8 | 1.3 | -0.3<br>2.9 | 1.5 | -0.7<br>3.7 | 2.1 | -0.1<br>4.3 |

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

*This forecast differs from our usual approach of deriving government consumption endogenously in the EFN econometric model. We think that at present government consumption is highly influenced by the fiscal crises in the euro area, factors that are not appropriately captured by the model. Instead, we assume that the time path of government consumption is compatible with the consolidation programs of the member countries.

## Economic Outlook for 2012 and 2013

### *Crisis of confidence in Europe slows growth of world economy*

At the end of 2011, the prospects for the world are clouded. High uncertainty is reflected by volatile stock market valuations in all major economies. The main cause for concern is that the euro area crisis of confidence apparently has not reached its peak yet. The restructuring of the Greek debt (in July and October) is the first de facto sovereign default in an advanced economy after the Second World War. Governments changed in all of the countries hit by the crisis. Yields for government debt of Italy and Spain are at present so high that it is doubtful whether debt service would be sustainable if they stay at these levels for long. Even more critical are the financing conditions for European banks whose standing crucially depends on the valuation of the sovereign bonds they own.

Economic growth has been sluggish since Spring 2011 in most regions of the world. In the US, however, the modest recovery has gained strength since Autumn, as structural problems concerning housing markets and indebtedness of private households seem to be slowly declining. But the recovery after the natural and nuclear disaster in Japan already appears to lose momentum. Weak demand from advanced economies dampens the expansion in export-oriented emerging markets countries (in East-Asia, but also in Latin America). For China and India, internal causes for slower growth are more important: for most of 2011, high inflation induced China to tighten credit growth, and for the same reason, India was raising interest rates. Due to weak growth dynamics and stagnating or falling commodity prices, worldwide inflation will calm down in the coming months. This gives room for monetary policy to become more expansive in most emerging markets economies; in Autumn, first steps were made in this direction in Brazil and China. In the advanced economies, key interest rates will be kept close to 0 for the whole of 2012, while fiscal policies will differ: Japan will continue on its expansionary path because repair programs are being implemented; in the US, fiscal policy is only mildly restrictive, as payroll tax breaks will probably be prolonged and Congress has decided for budget cuts that do not come into force before 2013. In the euro area (as well as in Britain) efforts to consolidate public households will have a strong restrictive effect on the economy. The ECB has decided on quite extensive measures to secure refinancing of European banks, and therefore, this forecast assumes that a major banking crisis can be avoided. Still, the stagnation of the euro area will provoke a downswing in central European countries and contribute to the weakness of British growth in 2012. Although chances are good that the US economy is slowly strengthening and that Asian growth will accelerate in midyear, we forecast world trade growth to be only 4%, almost 2 percentage points below its trend.

Two risks for this scenario appear particularly noteworthy: first, the recent slowdown in the Chinese economy has pricked a housing bubble. As the construction sector is of particular importance in China, it is not clear that policy will be able to stimulate the Chinese economy as quickly as it did after the financial crisis in 2009. The second risk is, of course, an escalation of the confidence crisis in Europe. What if Italy, Spain or some major banks were shut out from financial markets? It seems safe to assume that European policy, in one way or another, would prevent insolvencies in such cases, for the simple reason that a policy to defend the common currency "at any price" is in place. But confidence in the long run viability of the common currency could erode further, with negative short term effects on the euro area economy and beyond.

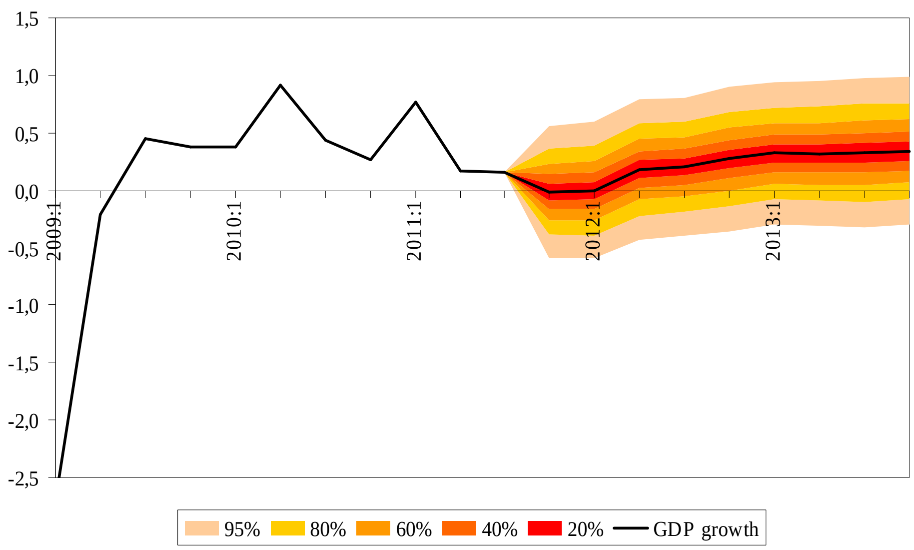
### *Stagnation in the euro area*

This forecast is derived under the assumption that no major shock hits the euro area economy. Still, production in the euro area slightly contracts in the Winter 2011/12. This is also what early indicators suggest, e.g. the steep decline in orders for the manufacturing sector and fading confidence among firms and households. Labour market conditions have been deteriorating since Summer: between June and October, the unemployment rate has increased by 3 percentage points up to 10.3%. Production expanded only slowly in the second and third quarters of 2011 (with an annualized growth rate of little more than 0.6%), and the output gap started rising again. At the same time, gross fixed capital formation was about stagnant. While inventories contributed negatively to growth in the third quarter, private consumption accelerated a bit, as some factors (the commodity price hike in particular) that had dampened demand by households before no longer applied. Due to the fiscal crisis, public consumption has now been more or less constant for a year. Only exports expanded at a healthy pace during the first three quarters of 2011.

The divide between a crisis in peripheral economies and a recovery in core countries has been blurred in the course of the year. The production has slowed or stopped growing in France, the Netherlands, and Belgium, and sentiment indicators in these countries approach levels found in the crisis countries. Somewhat more robust is, at present, confidence of firms and households in Germany. Most certainly, this pattern results from the spread of the crisis of confidence into countries such as Belgium and even, to a lesser extent, to France. As a reaction, new packages for consolidation have been announced for these states in Autumn.

The prospects for 2012 are bleak. Uncertainty will induce firms and households to postpone decisions on spending and investment, and fiscal policy will dampen demand further: the cyclically adjusted public deficit will be reduced by about one percentage point relative to GDP. Financial conditions are also bound to deteriorate in most member countries: refinancing costs for financial institutions have increased markedly in the short as well as in the long run; meanwhile, beginning in June 2012, banks in the European Union will have to fulfil more demanding requirements for capital. The strong efforts of the ECB to improve liquidity condition will only mitigate the pressure. Banks will react by tightening their credit standards, and costs of investment for firms and households will go up. Still, this report does not forecast a deep recession, mainly because demand in some member countries (notably in Germany) and from abroad will stay stable during winter and expand moderately afterwards. GDP is, with 0.3%, forecast, to be close to stagnating in 2012. For 2013 we expect production to expand by 1.2%, which is a bit higher than the presently quite low rate of potential growth.

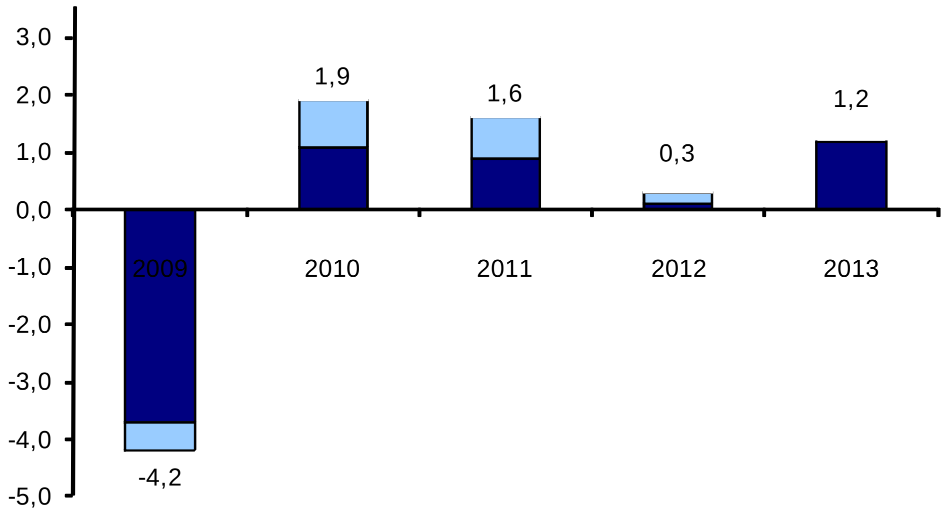
**Figure 1 Quarterly GDP growth rates and confidence bands**




Percentage change over previous quarter

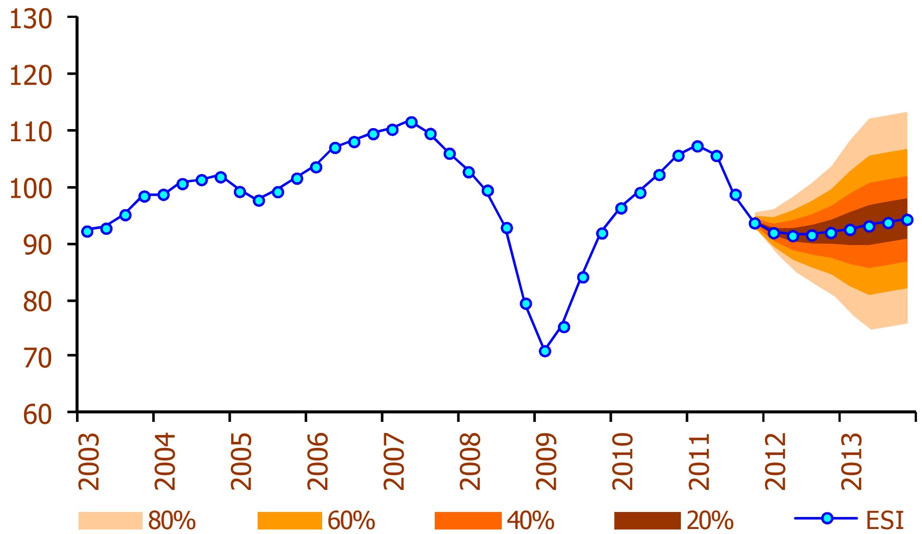
When it comes to inflation in the euro area, even if its speed of moderation in the last months has been slightly lower than forecasted, our prospect for 2012 – 1.8% – still remains below the maximum level set by the ECB's mandate (figure 4). Although the European monetary authority might not take stronger actions in the sovereign bond markets until a clearer fiscal union is agreed between the Member States, the expected favourable inflation conditions in the medium term facilitate a clearer expansive stance by the ECB, as suggested in our previous report.

**Figure 2 Contributions of domestic components and net exports to GDP growth**



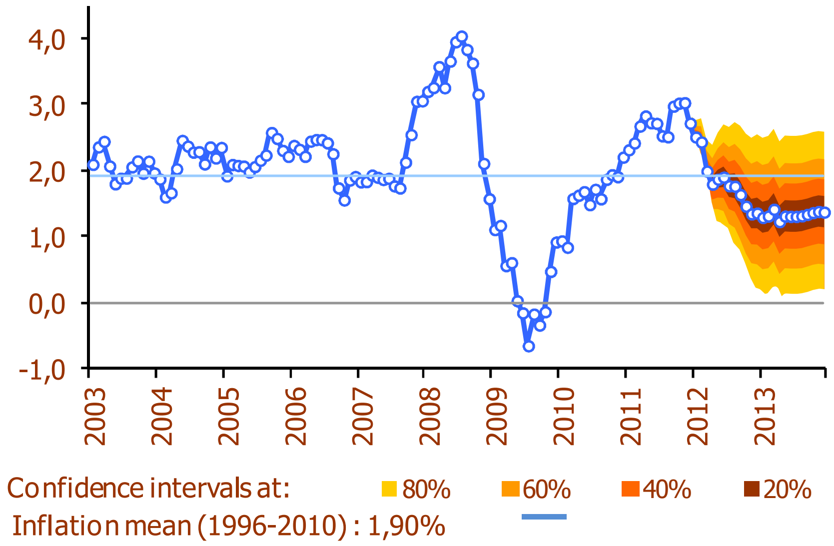

Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

**Figure 3 Economic Sentiment Indicators and confidence bands**




According to our forecasts, inflation will continue its decreasing trend in 2013, to 1.3%. A likely moderation of the global oil demand and the reduction of the political tensions in most leading oil producing countries in northern Africa allows us to rule out any significant energy prices hike during the forecasting horizon.

**Figure 4 HICP inflation and confidence bands**




With respect to industrial production, our growth forecasts for 2012 have slightly decreased to 1.5%, due to two main factors. First, the confidence crisis will continue postponing investment and consumptions decisions in the euro zone. Second, our exports prospects have slightly deteriorated since the weak demand from advanced economies might continue dampening the expansion of most emerging markets countries in the coming months. The forecast for the industrial production growth in 2013 is 2.1%. Table 2 summarizes the expected evolution of the different industrial production components over our forecasting horizon.

**Table 2 Annual average rates for industrial production in the euro area**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Durable | -5.2 | -17.3 | 2.5 | 0.8 | -5.8 | -4.0 |
| Non Durable | -1.3 | -2.9 | 3.5 | 1.3 | 0.8 | 1.1 |
| Capital | 0.0 | -20.9 | 9.1 | 9.1 | 6.6 | 6.8 |
| Intermediate | -3.4 | -19.0 | 10.1 | 4.3 | -0.8 | -0.1 |
| Energy | 0.2 | -5.3 | 3.8 | -4.4 | -1.3 | -0.9 |
| Total | -1.6 | -14.8 | 7.4 | 3.8 | 1.5 | 2.1 |

### *Comparison with alternative forecasts*

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

As to GDP in 2012, forecasts are quite close to each other (except the more optimistic, but less recent one from the IMF). The EFN forecast is on the optimistic side for investment activity. This is so because in countries that are less affected by the crisis of confidence the user costs of capital are low and will keep investment activity expanding.

Concerning inflation, our forecasts for 2012 are in a central position compared to those of other institutions. For 2013, our prospects are in the lower bound, although they are close to the one most recently updated, that of the OECD.

**Table 3 Comparison of EFN forecasts with alternative forecasts**

| | EFN | | EU | | IMF | | ECB | | OECD | | Consensus | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 |
| GDP | 0.3 | 1.2 | 0.5 | 1.3 | 1.1 | na | 0.3 | 1.3 | 0.2 | 1.4 | -0.1 | na |
| Priv. Consumption | 0.3 | 0.8 | 0.4 | 1.0 | 0.6 | na | 0.1 | 0.9 | 0.1 | 0.9 | 0.1 | na |
| Gov. Consumption | -0.3 | 0.2 | -0.2 | 0.3 | -0.1 | na | 0.1 | 0.5 | -0.3 | -0.2 | -0.2 | na |
| Fixed Capital Form. | 1.0 | 2.2 | 0.5 | 2.9 | 1.8 | na | 0.1 | 1.9 | -0.4 | 2.3 | -0.2 | na |
| Unemployment rate | 10.6 | 11.2 | 10.1 | 10.0 | 9.9 | na | na | na | 10.3 | 10.3 | 10.5 | na |
| HICP | 1.8 | 1.3 | 1.7 | 1.6 | 1.5 | na | 2.0 | 1.5 | 1.6 | 1.2 | 1.8 | na |
| IP | 1.5 | 2.1 | na | Na | na | na | na | na | na | na | -0.6 | na |

EU: European Commission, Economic Forecast, November 2011; IMF: World Economic Outlook, October 2011; ECB: ECB Monthly Bulletin, December 2011, OECD: Economic Outlook, November 2011; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2011. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

**Variables of the world economy**

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 4 below. We assume that the recovery in the US slowly gains pace in 2012 and 2013, but that world trade is clearly below its long term growth path in 2012. Oil prices are expected to be about constant in real terms. As well, the exchange rates of dollar and yen relative to the euro are assumed to be stable.

**Table 4 Variables of the world economy**

| | 2012 | 2013 |
|---|---|---|
| US GDP Growth Rate | 2.1 | 2.5 |
| US Consumer Price Inflation | 2.1 | 2.3 |
| US Short Term Interest Rate (December) | 0.1 | 0.6 |
| US Long Term Interest Rate (December) | 2.8 | 3.6 |
| Japan GDP Growth Rate | 2.1 | 1.6 |
| Japan Consumer Price Inflation | -0.2 | 0.0 |
| Japan Short Term Interest Rate (December) | 0.3 | 0.3 |
| Japan Long Term Interest Rate (December) | 1.2 | 1.3 |
| World Trade Growth Rate | 4.0 | 6.7 |
| Oil Price (December) | 113 | 116 |
| USD/Euro Exchange Rate (December) | 1.34 | 1.34 |
| 100Yen/Euro Exchange Rate (December) | 1.04 | 1.04 |

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2011). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.